October 21, 2008

Testimony of the Investment Company Institute
Hearing on Proposed Regulation and Class Exemption for Investment Advice
Employee Benefits Security Administration
U.S. Department of Labor

Introduction

My name is Jon Breyfogle. I am the managing partner of the Groom Law Group and I have the pleasure of testifying on behalf of the Investment Company Institute ("ICI"). ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts.[1]

ICI appreciates the opportunity to provide testimony on the Department of Labor's proposal regarding the provision of investment advice to participants and beneficiaries of self-directed individual account plans and IRAs. The interest of ICI members in this exemption is substantial. Mutual funds hold nearly half of all 401(k) and IRA assets. Mutual funds and their affiliates also serve as 401(k) plan recordkeepers and provide other services to defined contribution plans and IRAs.

The Department has proposed a Regulation implementing the statutory exemption for investment advice that Congress added under the Pension Protection Act of 2006 ("PPA"). The Department has also proposed a prohibited transaction Class Exemption providing relief for certain investment advice transactions similar to those covered by the statutory exemption.

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[1] Members of ICI manage total assets of $12.4 trillion and serve almost 90 million shareholders. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors and advisers.

ICI strongly supports both the proposed Regulation and Class Exemption. These proposals will significantly encourage plans and providers to offer individualized investment advice programs to assist ERISA plan participants and IRA investors in managing their accounts.

The need for investment advice programs is clear. The GAO recently concluded that only 47% of ERISA plans offered some form of investment education to participants.[2] This contrasts with the 80 percent of households owning mutual funds outside of defined contribution plans that purchased their funds using a professional financial adviser.[3] This data shows that investment advice is much less widely available for retirement plans, and we believe that the Department's proposal would remove obstacles that currently contribute to this disparity.

Robust investment advice services are particularly necessary in light of the current financial crisis, which has made Americans saving for retirement understandably anxious about their accounts. Investment advice services can help to ensure that participants in ERISA plans and IRAs understand the long-term nature of retirement savings and assist them in assembling and maintaining a diversified portfolio. Failure to finalize the proposal will greatly limit the ability of participants to gain access to needed investment advice programs.

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[2] U.S. Government Accountability Office, GA0-07-355, Employer-Sponsored Health and Retirement Plans: Efforts to Control Employer Costs and the Implications for Workers, at 36 (Mar. 2007), available at http://www.gao.gov/new.items/d07355.pdf.

[3] Investment Company Institute, Ownership of Mutual Funds Through Professional Financial Advisers, 2007 (Sept. 2008), available at http://www.ici.org/statements/res/fm-v17n4.pdf.

Proposed Class Exemption

Section 408(a) of ERISA empowers the Department to adopt a conditional or unconditional exemption for a class of transactions from the restrictions imposed by ERISA's prohibited transaction provisions. In order to grant such an exemption, the Department must determine that the exemption is administratively feasible, in the interests of plan participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan. For an exemption that provides relief from section 406(b) of ERISA, the Department must afford an opportunity for a hearing and make a determination on the record that these three conditions are met.

The Department has received some comments suggesting that the Class Exemption exceeds the Department's authority, or that it is inconsistent with the statutory exemption. The ICI disagrees with these comments for several reasons.

- The statutory exemption in no way modified the authority of the Department to issue new class exemptions pursuant to its broad authority under section 408(a). It is that authority that provides the basis for the Class Exemption.
- The class exemption is not at odds with the Department's past practices in issuing prohibited transaction exemptions. The statutory exemption expressly preserves prior exemptions issued by the Department. Many of the Department's prior exemptions provide relief from section 406(b) without mandating fee leveling or computer models. For example, PTE 75-1 covers advice to buy or sell unaffiliated mutual funds. PTE 84-24 covers advice to purchase insurance contracts or affiliated mutual funds.

PTE 86-128 covers commissions paid to broker dealers that exercise discretion over plan portfolios. There has never been any showing of abuse with respect to such class exemptions, nor has there ever been any question as to the Department's authority to issue such exemptions. We disagree with the comments that suggest that the Class Exemption is inconsistent with the terms of the new statutory exemption and the Department's long history of regulating in this area.

- It is incorrect to argue, as some have, that the Department must construe the new statutory exemption to mandate complete fee leveling across all affiliates of a financial firm. If that view were adopted, the exemption would not be needed. In its Frost Bank Advisory Opinion, the Department made clear that such programs do not even violate the prohibited transaction rules and therefore do not need an exemption to begin with. It is a settled principle of statutory interpretation that regulators and courts must give meaning to statutory provisions, and the fee leveling approach adopted in the Regulation, and expanded upon in the Class Exemption, do just that.
- It is also incorrect to argue that the so-called "off-model" advice provision in the Class Exemption is inconsistent with the statutory exemption because the statutory exemption requires that all transactions be at the direction of the participant. The Class Exemption retains that very condition and, in so doing, ensures that fiduciary advisers cannot exercise discretion over plan accounts, they can only give non-binding

> recommendations. Moreover, the provision of off-model advice derives from the terms of the statutory exemption, which clearly allows participants to seek advice in addition to the recommendations provided by a computer model. The issue is, however, whether any subsequent advice would have been covered by the statutory exemption.

The ICI strongly believes that each of the conditions imposed by section 408(a) are met by the proposed Class Exemption.

First, the Class Exemption is clearly administratively feasible. Although the conditions are significant, fiduciary advisers will be able to develop compliance programs and comprehensive disclosures that meet the requirements of the Class Exemption. And, the Class Exemption makes two of the key conditions in the statutory exemption considerably more feasible to implement. In this regard, the statutory exemption clearly contemplates that an adviser using a computer model program may be asked by the participant for additional advice beyond the model, or "off-model" advice. But the statutory exemption does not address whether the fiduciary adviser would have relief if it were to provide this kind of off-model advice. The Class Exemption resolves this anomaly in the statutory exemption by permitting off-model advice, provided that certain conditions – that go beyond those in the statutory exemption – are met. That is, off-model advice can be provided only after unbiased computer generated investment recommendations are presented, and only if the fiduciary adviser concludes such additional off-model advice is in the interest of plan participants. The Class Exemption, therefore, makes more feasible an idea inherent in the statute.

The Class Exemption also would resolve the anomalies in the statutory exemption with respect to fee leveling. As noted above, the Department's pre-PPA guidance concluded that no prohibited transaction would occur if an advice arrangement involved fee leveling at every level in the provider's organization.[4] While the condition in the statutory exemption for fee leveling obviously meant to go beyond the Department's pre-PPA guidance in Frost Bank, the statutory exemption does not specify exactly where fee leveling applies. The Class Exemption would make fee leveling workable for organizations using a variety of business models by applying fee leveling in the place it makes the most sense: to the individual with discretion to provide advice to a participant.

The ICI also believes that expanding the range of advice programs available to participants as provided for under the Class Exemption is in the interest of participants, as required under section 408(a). Congress made a clear decision that it was in the interests of participants to expand the opportunity for participants in ERISA plans and IRAs to receive investment advice. It is well documented that advice programs can be useful and are not widely available. All policymakers expected that this important new PPA statutory exemption would foster new advice programs that did not exist under prior law and encourage employers to adopt these advice programs.[5] As explained above, the

[4] DOL Adv. Op. 2005-10A (May 11, 2005); DOL Adv. Op. 97-15A (May 22, 1997).

[5] On the day the PPA was signed, President Bush stated that the Act "would provide greater access to professional advice about investing safely for retirement." http://www.whitehouse.gov/news/releases/2006/08/20060817-1.html. Senator Enzi, Chairman of the Conference Committee, lauded the Exemption as "provid[ing] much needed financial advice and guidance for the millions of workers and their families on how to invest their hard earned monies for retirement . . . ." 151 Cong. Rec. S8752 (Aug. 3, 2006). Senator Kennedy stated that "Workers who participate in retirement savings plans will have greater access to investment advice to help them manage their retirement savings." Id. at S8754.

Class Exemption addresses anomalies in the statutory exemption to make computer based and fee leveling advice programs workable in the marketplace.

The Class Exemption includes a myriad of provisions that are intended to ensure that the rights of participants are well protected, as required under section 408(a). Key conditions require that:

- The arrangement is expressly authorized by an independent plan fiduciary;
- Investment advice is provided pursuant to a computer model or level fees approach;
- Investment transactions occur solely at the direction of the recipient of the investment advice;
- Investment advice is based on generally accepted investment theories;
- The fiduciary adviser provides comprehensive advance and ongoing written disclosures (including disclosures of all direct and indirect fees and material affiliations and relationships between the adviser and investment products);
- The fiduciary adviser obtains an annual audit and report from an independent auditor;
- The fiduciary adviser adopts and maintains written compliance procedures;
- The compensation received by the fiduciary adviser and affiliates is reasonable; and
- The fiduciary adviser retains records for six years.

In addition to these conditions, the Class Exemption provides other protective conditions that guard against potential conflicts of interest where the fiduciary adviser provides off-model advice after utilizing a computer model. The Class Exemption would not permit a fiduciary adviser to provide off-model investment advice that may generate greater income than other investment options of the same asset class for the fiduciary advisor, any employee, registered representative, any affiliate, or a person with a material affiliation without the fiduciary adviser first determining that the recommendation is in the best interest of the participant or beneficiary and then explaining this finding to the participant or beneficiary.

It is also worth emphasizing that, like the statutory exemption, the Class Exemption requires that a fiduciary adviser must be one of several federal-regulated entities. This condition serves to provide additional protections under regulatory schemes outside of ERISA, which include their own comprehensive regulation and disclosure requirements for conflicts of interest. For example, fiduciary advisers registered under the Investment Advisers Act of 1940 must comply with the fiduciary duty obligations of that law and are regulated by the SEC.[6] In relevant part, the Advisers Act requires investment advisers to:

- Eliminate or fully disclose all conflicts of interest that might incline the investment adviser to render advice that is not disinterested,

[6] The Supreme Court has interpreted Section 206 of the Advisers Act to establish a fiduciary duty for investment advisers to act for the benefit of their clients. In SEC v. Capital Gains Research Bureau Inc, the Court stated the Advisers Act "reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested." 375 U.S. 180 (1963).

- Adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act;
- Make annual filings to the SEC on Part I of the Form ADV; and
- Provide their advisory clients and prospective clients with a written disclosure document in advance that includes disclosure of conflicts of interest.[7]

Broker-dealers are regulated by the SEC under the Securities Exchange Act of 1934, which prohibits misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities.[8] Under these "antifraud" rules, broker-dealers must disclose certain material information the customer would consider important as an investor, charge prices reasonably related to the prevailing market, and fully disclose any conflict of interest. FINRA also regulates broker-dealer firms and imposes standards on member conduct through the FINRA Rules.[9]

Finally, ERISA's general fiduciary rules further serve to safeguard ERISA plan participants because the Class Exemption does not relieve fiduciary advisors from their fiduciary duties of undivided loyalty and prudence under ERISA section 404(a). Finally, the sanctions for noncompliance with the Class Exemption's conditions are severe –

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[7] See, e.g., U.S. Securities and Exchange Comm'n, Information for Newly-Registered Investment Advisers, available at http://www.sec.gov/divisions/investment/advoverview.htm.

[8] See, e.g., U.S. Securities and Exchange Comm'n, Guide to Broker-Dealer Registration, available at http://www.sec.gov/divisions/marketreg/bdguide.htm#V.

[9] See About the Financial Industry Regulatory Authority, at www.finra.org.

excise tax penalties under Code section 4975 and public and private enforcement actions under ERISA sections 409 and 502.

All of these protections, which are drawn directly from, or add to, the statutory exemption, ensure that participants in ERISA plans and IRAs are more than adequately protected from potential conflicts of interest that fiduciary advisers may have. Adding further restrictions would result in an impractical scheme that would be entirely inconsistent with the statutory exemption's fundamental purpose of expanding the types of available investment advice.

ICI strongly believes the overarching policy objective of expanding the types of available investment advice should guide the Department in finalizing the proposed Class Exemption. As proposed, the Class Exemption is consistent with the purpose of the statutory exemption while incorporating and expanding upon the statutory exemption's conditions that provide protections for participants in ERISA plans and IRAs. The Class Exemption meets the three conditions of ERISA section 408(a), and the Department should make such a determination on the record.

Additional Recommendations

While ICI supports both the proposed Regulation and Class Exemption, we recommend modest modifications and clarifications to enhance the overall workability and utility of the proposals, as we describe in our previously submitted comment letter to the Department.

First, the Department should clarify that in providing advice a fiduciary adviser need not take into account each and every factor listed in the Regulation and section

III(c) of the Class Exemption, including information relating to a participant's age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and investment preferences. Many advice programs do not ask for all of this information or take into account every one of these factors. It can be difficult to obtain information on all of the enumerated items (such as other assets or sources of income), and some participants are reluctant to provide this information. Some factors overlap or may be inferred from others (for example, age and life expectancy, or retirement age and risk tolerance). This clarification is consistent with the approach taken with respect to computer models and would be subject to the overall condition that the advice is based on generally accepted investment theories.

Second, the Department should clarify that a fiduciary adviser utilizing a computer model may limit its advice program to a subset of the plan's available investment options, provided the limitations are disclosed to the plan's independent fiduciary and the number and types of investment options included are sufficient to permit a participant to construct a prudently diversified portfolio. Both the Regulation and Class Exemption include a requirement that any computer model takes into account "all investment options under the plan." While the Department clarified that the requirement applies only to "designated investment options," a requirement to take into account all designated investment options may be unworkable in some circumstances and may inhibit the provision of advice in certain plans. Our letter included some specific situations in which further relief would be appropriate.

Finally, the Class Exemption provides that in the case of a "pattern or practice" of noncompliance with any of the conditions of the exemption, relief is unavailable with

respect to any advice by the fiduciary adviser during the period of noncompliance. The scope of this penalty is unclear, and the potential penalties so draconian and without precedent, that it may discourage advice providers from relying on the exemption.

The proposed Class Exemption includes myriad provisions that we believe make a "pattern or practice" rule unnecessary. For example, as a condition of the regulation, the adviser must adopt policies and procedures to ensure compliance. In addition, the adviser must hire an auditor to review compliance with the exemption. Finally, since the excise tax in section 4975 of the Internal Revenue Code applies to each transaction that is a prohibited, and generally "pyramids" in subsequent tax years until corrected, a fiduciary adviser has a strong interest in limiting any instances of noncompliance.

We recommend that in finalizing the Class Exemption the Department follow the same standard that applies for any other exemption – each transaction for which all the conditions are satisfied should be covered. Transactions for which the conditions are not satisfied should not be covered.

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Thank you for providing ICI the opportunity to provide testimony on the Department's proposed Regulation and Class Exemption. I would be happy to answer any questions you may have at this time.

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